

HONORABLE PHYLLIS J. HAMILTON

IN THE UNITED STATES COURT FOR THE  
NORTHERN DISTRICT OF CALIFORNIA  
SAN FRANCISCO DIVISION

CARL SCHLACHTE and  
NANCY SCHLACHTE,  
Plaintiffs,

v.

THE UNITED STATES OF AMERICA,  
  
Defendant.

*Case No. CV 07-06446 PJH*

PLAINTIFFS' BRIEF ON  
ADMINISTRATIVE EXHAUSTION

**INTRODUCTION**

The main issue before the Court is whether it has subject matter jurisdiction to consider the Plaintiffs' theft loss claim. The Court does have jurisdiction because the theft loss claim was raised and considered in the administrative hearing before the decision became final for administrative exhaustion purposes.

The Court has ordered further briefing limited to the question: "whether, for administrative exhaustion purposes, the IRS' decision disallowing plaintiffs' 2000 refund claim was final upon issuance of the original June 2006 denial, or whether the decision only became final for administrative exhaustion purposes after the IRS completed the appeal of the June 2006 denial."

1 The Schlachtes' theft loss claim was raised to the examining officer, Ms. Li, at the  
 2 initial hearing, but the only writing documenting that the claim was raised at the  
 3 examination level is Ms. Li's Examining Officer's Activity Record (Exhibit 3 to Declaration  
 4 of Brian G. Isaacson in Support of Plaintiffs' Opposition to Motion to Dismiss, filed May 6,  
 5 2008). Ms. Li's report also shows that Mr. Isaacson's position was that the IRS did not know  
 6 [when] the actual sales of stock occurred. *Id.* Plaintiffs assert that they have been unable to  
 7 get the IRS to assert a date of "sale" for the stock as necessary for the theft loss computation.  
 8 The written protest requesting Appeals office consideration also raised the theft loss claim.  
 9 (Ex. 4 to Isaacson Decl.). Appeals considered the theft loss in the Appeals Case Memo. (Ex.  
 10 2 to Isaacson Decl.). The question appears to be whether this consideration was before, or  
 11 after, the decision became final for administrative exhaustion purposes.  
 12

### 13 DISCUSSION

#### 14 I. Administrative Remedies Not Exhausted Until the Appeals Process Is Completed

15 Treasury Regulation § 301.7430-1 is entitled "Exhaustion of administrative  
 16 remedies." The Regulation provides:  
 17

18 ... A party has not exhausted the administrative remedies available within the  
 19 Internal Revenue Service with respect to any tax matter for which an Appeals office  
 20 conference is available under §§ 601.105 and 601.106 of this chapter ... unless--  
 21 (i) The party, prior to filing a petition in the Tax Court or a civil action for refund in  
 22 a court of the United States (including the Court of Federal Claims), participates,  
 23 either in person or through a qualified representative ... in an Appeals office  
 24 conference; or  
 25 (ii) If no Appeals office conference is granted, the party, prior to the issuance of a  
 26 statutory notice in the case of a petition in the Tax Court or the issuance of a notice  
 of disallowance in the case of a civil action for refund in a court of the United States  
 (including the Court of Federal Claims)--  
 (A) Requests an Appeals office conference in accordance with §§ 601.105 and  
 601.106 of this chapter; and  
 (B) Files a written protest if a written protest is required to obtain an Appeals office  
 conference.

1 The required participation in the administrative process includes the appeals process.  
 2 *Polyco, Inc., v. Commissioner*, 91 T.C. 963 (1988). Therefore, exhaustion can only be  
 3 determined at the end of the appeal and exhaustion logically does not occur until the appeal  
 4 is completed.

5 In addition, local IRS offices, and local IRS officers, lack the ability to make a final  
 6 determination of the amount of tax owed and, therefore, can not make a final determination  
 7 of the amount of a refund owed to a taxpayer claiming a refund. This proposition is  
 8 explained in a widely accepted treatise on tax procedure:  
 9

10 In general terms, the Office of Appeals has the “exclusive and final authority” to  
 11 determine liability for most taxes in cases originating in a local office located within  
 12 its area. (SPR, 26 CFR § 601.106(a)(1)). Appeals authority is exclusive because it is  
 13 independent of the functions from whose determinations taxpayers appeal. (Before  
 14 its 1998 reorganization, the Statement of Procedural Rules stated that the Appeals  
 15 Office represents the Regional Commissioner in “his/her exclusive and final  
 16 authority” (SPR, 26 CFR § 601.106(a)(1)(ii)) and that under certain conditions the  
 17 Regional Commissioner may assume direct control over a case in the Appeals Office  
 18 (26 CFR § 601.106(c)(3)). The Exclusive authority of the Appeals Office to make  
 19 final determinations, including settlements, also appears to result from the fact that  
 20 this delegation of authority runs directly from the Commissioner of Internal  
 21 Revenue). Reaffirming the independence of Appeals representatives, the Statement  
 22 of Procedural Rules states, “It shall be [the Appeals Officer’s] duty to determine the  
 23 correct amount of tax, with strict impartiality between the taxpayer and the  
 24 Government, and without favoritism or discrimination as between taxpayers.” (SPR,  
 25 26 CFR § 601.106(f)(2) (Rule I)). Appeals authority is final because there is no  
 26 appeal from an Appeals Office decision to any other office in the Service. As a  
 result, Appeals Offices serve as tribunals of last resort within the Service.

Michael I. Saltzman, IRS Practice and Procedure, § 9.03 (Revised Second Edition, 2002).

Because only the Appeals office has the “exclusive and final authority” to determine  
 the Schlachtes’ refund there could not have been a final determination on the merits of their  
 claim or a final rejection of their refund claim until the conclusion of the appeals process.  
 Because the Schlachtes’ theft loss claim was raised and considered both during the

1 examination and at appeals (which had to be before the final rejection or final determination  
2 was made), the Court has jurisdiction to consider the theft loss claim in this action.

3 **II. Exhaustion Does Not Occur If Appeals Has Signaled That It Will Reconsider a**  
4 **Claim.**

5 Claims arising when Appeals reconsiders a denial can be amended where (as here)  
6 the expiration of the period for filing a refund claim has not expired. In *Youngstown Sheet*  
7 *and Tube Company v. U.S.*, 79 Ct. Cl. 683 (1934), the Court of Claims ruled that the  
8 Commissioner was allowed to reconsider a prior denial and the taxpayer was allowed to  
9 amend the claim while it was under reconsideration even if the period for submitting a  
10 refund claim had expired. In *U.S. v. Andrews*, 302 U.S. 517, 526-27 (1938), the Supreme  
11 Court of the United States modified the *Youngstown* holding only to the extent that the  
12 amendment was required to have been made before the expiration of the period for filing a  
13 refund claim. This indicates that a refund claim is still allowed to be modified during a  
14 period where it is under reconsideration by Appeals and therefore that the final  
15 determination and administrative exhaustion do not occur until after any announced  
16 reconsideration of a refund claim by Appeals is completed. Therefore, even if the refund  
17 claim was denied, it was timely amended (Ex. 4 to Isaacson Decl.). It was then considered  
18 by Appeals as shown by Mr. Cunningham's Appeals Case Memo (Ex. 2 to Isaacson Decl.).  
19 Because this occurred before final determination (and administrative exhaustion), as shown  
20 by the *Youngstown* and *Andrews* cases, so the Court has jurisdiction to consider the theft  
21 loss claim in this action.

24 **III. Exhaustion May Not Be the Determinative Factor Because the Theft Loss Claim**  
25 **Was Adequately Presented Before Ms. Li**

26 Mr. Isaacson's telephone call to Ms. Li regarding the theft loss claim, together with

1 Ms. Li's note in her Examining Officer's Activity Record regarding the telephone call,  
2 adequately establish an informal claim for refund.

3 The Court was asked to consider *Stevens v. U.S.*, 2006 U.S. Dist. Lexis 45611, 98  
4 A.F.T.R.2d (RIA) 5184 (N.D. Cal. June 26, 2006). In the *Stevens* opinion, Justice Conti  
5 stated: "[S]everal cases have addressed ... whether internal government documents alone  
6 can suffice as the written component [of an informal refund claim]. The consensus among  
7 them is that it can." *Id.* at 18-19 (citations omitted).

8 The Court might also consider *Computervision Corporation v. U.S.*, 444 F.3d 1355,  
9 1365-1368 (Fed. Cir. 2003), and *The Western Company of North America v. U.S.*, 323 F.3d  
10 1024, 1035 (Fed. Cir. 2006). The Plaintiffs' situation is similar to Western's; despite the  
11 Schlachtes' requests the IRS would not provide the date of the "sale" they were claiming  
12 occurred. This information is necessary to make a formal theft loss claim because the  
13 economic loss required by IRC § 165(a) is the difference between what was received and the  
14 fair market value of the stock at the date of sale.  
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16  
17

18 DATED this 4th day of June, 2008.

19 ISAACSON & WILSON, P.S.

20 /s/ Mark J. Wilson  
21 Mark J. Wilson, Cal. Bar No. 96985  
22 Attorney for Plaintiffs  
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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the foregoing was delivered on June 4, 2008 to the CM-ECF system of the United States District Court for the Northern District of California for electronic delivery to all counsel of record.

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